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## *Strategies to Enhance the Payout Phase of the Retirement Benefits*

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**PREPARED BY:**

AMOS G. NJUGUNA

LEAH MUTANU

KENNEDY OTSOLA

This research was a joint project between the Retirement Benefits Authority (RBA) and the United States International University (USIU). The findings, interpretations and conclusions are those of the authors and do not necessarily represent those of the Retirement Benefits Authority or United States International University.



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UNITED STATES INTERNATIONAL UNIVERSITY

P. O. Box 14634 - 00800, NAIROBI, KENYA, EAST AFRICA

**PHONE:** +254.20.3606000 | **Fax:** +254.20.360 6100

[admit@usiu.ac.ke](mailto:admit@usiu.ac.ke) | [www.usiu.ac.ke](http://www.usiu.ac.ke)

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# Executive Summary

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In July 2012, RBA and USIU undertook a joint research project in Kenya with six specific objectives namely; (i) to characterize the annuities market in terms of volumes and values traded (ii) to establish whether annuitants understand the features of annuities (iii) to determine the challenges in annuity provision to pensioners (iv) to determine the effect that annuities have on pension replacement rates (v) to explore alternatives to annuities in retirement income provision (vi) establish policy reforms that RBA can take to ensure that pensioners get value out of their retirement incomes.

## Methodology

Mixed research design was applied to collect data on both the supply and demand sides in the distribution of retirement income in Kenya. Respondents in the supply side were the 8 insurance companies offering annuities, the Insurance Regulatory Authority and the 21 pension administrators in Kenya by 30 July 2012 while those in the demand side were 361 pensioners randomly selected from the sampling frame of the pensioners in the Retirement Benefits Authority's register on 30 July 2012.

## Key Findings

1. In the three years to 2011, the 8 insurance companies providing annuities in Kenya, opened 14007 annuity accounts of which 29% were life annuities
2. Ninety two percent of the annuity business in Kenya is controlled by 3 major companies namely ICEA Lion (51%), Jubilee Insurance Company (27%) and Pan Afric Life (14%)
3. The total amount invested in the 3 year period in annuities was Ksh. 20.1 billion (2009 – Ksh. 5.6 billion; 2010- Ksh. 6.3 billion and 2011-Ksh. 8.2 billion), with 92% of the funds invested in the three main companies.
4. The average investment per annuitant reduced by 7% in 2010 compared to 2009 (Ksh. 1.5 million to Ksh. 1.4 million). In 2011, the average investment remained the same as 2010 as a result of volatility in the financial markets.
5. Although the pensioners were aware of the existence of the annuity market, 69% did not understand how their annuity premiums were determined, 64% did not understand inflation adjustment clauses in annuities and 60% did not have a good understanding of the insurance companies that offer annuities, 56% did not know the rates of return they could expect on their annuities and 39% could not tell the date of expiry of their annuities.
6. The annuity replacement rate is 19.2% while the aggregate replacement rate is 34.3%

7. Annuities have helped the annuitants to; have secure income (79%), prevent misuse of funds (74%), be self dependant (73%) improve their social standing (69%), access medical covers (68%), get tax advantages (68%), provide for their dependants (66%)
8. Annuities have however not helped the annuitants to manage the inflation risk they are exposed to (86%) and access loans from financial institutions (59%)
9. The main problems that service providers face in providing retirement income are adverse selection, pricing of annuities, increasing longevity of the clients, failure to meet annuitant's expectations, regulatory constraints and low understanding on annuities by the clients
10. The main alternatives available to the use of annuities in providing retirement income are income draw downs and lump sum payments. Hybrids of the various models are also available.

### **Recommendations**

1. Regulators and annuity providers should collaboratively provide market information with regard to annuities to alleviate both demand and supply side challenges in the annuity markets
2. The accumulation phase of retirement income should continuously be strengthened to increase the replacement rates
3. Annuity products should be standardized to ensure that insurance companies compete on the basis of price, efficiency and effectiveness as opposed to product features.
4. The payout phase of the retirement cycle should be redesigned to include lump sum payments, variable annuities, income drawdown and deferred annuities options to provide a balance between flexibility and liquidity on one end and longevity on the other
5. Regulation should focus on the review of longevity tables to reflect the real value of annuities.

# Introduction

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The recent trend in the pension fund industry is the conversion of pension designs from defined benefit to defined contribution as well as the conversion of pension schemes in favour of provident schemes to provide liquidity at retirement. These trends subject savers to market risks in the light of volatilities in the financial markets during the accumulation phase of their retirement benefits (Whitehouse, 2010) which in turn lowers the retirement benefits due at the benefit payout stage and fails to insulate participants against longevity risk. Empirical studies have proven that the choice of the payout model at the retirement point can significantly affect the value of the retirement benefits (Antolin, 2010).

Difficulties in the design of the payout phase of the retirement system arise because the parameters affecting pension benefits namely; life expectancy after retirement, returns on investments and inflation are uncertain. As a result, the process of disbursing retirement income entails inherent risk that both the providers and consumers must manage in a state of information asymmetry, volatile financial markets, irresolute regulation and longevity risk.

Annuities are key financial products that provide pensioners with a steady stream of income, allows savings to grow, offers tax advantages and provide a safe mode of investment to the pensioners (Morales and Rocha, 2006; Rusconi, 2008, Antolin, 2010). However, insurers argue that annuities are not profitable to underwrite, markets are competitive and annuity products are particularly risky to underwrite especially in developing countries (Doyle and Piggot, 2000; Orszag, 2000, IOPS, 2008).

The main problems facing annuity providers relate to adverse selection and mortality risk associated with mortality improvements and to interest rate, reinvestment and inflation risk (Blake, 1999; Blake and Hudson, 2000; Keizi, 2007). Morales and Rocha (2006) mention other problems as; the use of outdated tables that fail to reflect the modern market conditions, governance issues in the management of the insurance companies and mispricing. Annuities therefore, only partly meets the needs of the pensioners given the availability of different assets outside the formal pension systems, the changing patterns of work, longevity and lifestyle.

In many parts of the world, there is no compulsion to purchase annuities at the payout phase of the retirement benefits. Some countries such as Australia and the United States of America allow individuals a high degree of freedom of access to the proceeds of their retirement income once they retire; others (Chile, Singapore and Ireland) allow freedom of access once a minimum income or minimum fund has been secured and as such the purchase of the annuity is just one of a number of alternative arrangements for generating retirement income security (Blake and Hudson, 2000; Stewart, 2007).

RBA estimated the value of retirement assets in Kenya by 31 December 2012 at Ksh. 549 billion; about 30% of the country's GDP. With the current rules on dispersion of retirement income, a huge proportion of this amount will be invested in the annuities market in Kenya. This calls upon the development of a sustainable annuities market to ensure that pensioners get value for their long-term retirement savings. Keizi (2007) acknowledges that significant problems engulf the annuities market in Kenya, which result to annuity buyers having "a raw deal for value of their money" and advises further research on this area.

Today, the pension crisis has hit the world and many people are living longer than it was in previous centuries. This trend will only result to significant gains to the pensioners if financial markets are efficient and well thought out policies are implemented in the provision of retirement income.

This paper reviews the payout phase of retirement benefits provision in Kenya. It addresses the critical issues surrounding annuity markets in both the demand and supply side, determines the replacement rates for pensioners under the current payout model and proposes creative models that can be implemented to ensure value for money for pensioners.

## **Current Retirement Benefit Payout Model in Kenya**

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Two avenues of disbursing retirement benefits in Kenyan defined contribution schemes are annuities and income draw down. Prior to 2012, withdrawals from the individual retirement schemes were based on a model that allowed a 50% lump-sum payout followed by an investment of the remaining 50% in annuities. This model was complimented by the implementation of Regulation 25(6) of the Retirement Benefits (Occupational Retirement Benefits Schemes) Regulation under Legal Notice Number 77 of 2008 that allowed retirement benefits schemes to offer income draw downs provided that the drawdown period shall not be less than ten years and the scheme rules allow for a drawdown arrangement. The drawdown model provides flexibility to members with regard to income withdrawals, date of retirement and asset selection and enhances the bequest motive of the members but does not provide guarantees in respect of retirement benefits and places longevity and investment risks squarely on the pensioners. The option is however limited to members with capacity to invest at least Ksh. 5 million in the draw down fund of the retirement benefits scheme. To curb the longevity risk, the model mandates investment in annuities for any amounts remaining in the fund once the pensioner attains the age of seventy five.



## 1.1 General Objective of the Study

The main objective of the study was to critically review the current retirement benefits payout model in Kenya and devise strategies that can be used to enhance it.

## 1.2 Specific Objectives

The study was guided by the following objectives;

- (a) To characterize the annuity market in Kenya in terms of volumes and values traded
- (b) To establish whether annuitants understand the features of annuities
- (c) To determine the challenges in annuity provision to pensioners in Kenya
- (d) To determine the effect that annuities have on replacement rates of the pensioners
- (e) To explore alternatives to annuities in retirement income provision in Kenya
- (f) To establish policy reforms that RBA can take to ensure that pensioners get value out of their Retirement incomes

## Methodology

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### 2.1 Research Design

A mixed research design was used to execute the study on both the supply and demand side of the provision of retirement income. For the supply side, a qualitative study involving the key informants in the life insurance industry in Kenya was conducted. Two participants were drawn from each of the eight companies that offer annuities in Kenya. Additionally, informants were also invited from IRA, pension fund administrators and actuaries. In total, 43 respondents participated in the different focus group discussions. With regard to the demand side, the design involved the conduct of three focus group discussions, which formed the basis of development of the questionnaire. The questionnaire was then distributed to a wider group of respondents.

### 2.2 Population

The supply side aspect of the population consisted of the stakeholders in the Kenyan annuity market namely; 8 insurance companies, 21 pension administrators, RBA and IRA. The demand side population consisted of all the pensioners who were earning pension on the annuity provision model on 31 August 2012 in Kenya. The sampling frame was constructed on the basis of the list of pensioners that was obtained from RBA.

### **2.3 Sampling Design and Size**

The supply side of the study consisted of a census since the number of players was limited while the demand side aspect of the study sampled 450 pensioners by use of simple random sampling.

### **2.4 Data Collection Method**

Self-constructed questionnaires and interview guides were used to collect the data. The instruments were developed based on the existing literature review and the results of the qualitative studies. The instruments were first piloted to improve on their validity and reliability.

### **2.5 Research Procedures**

Key respondents for the supply side study were identified from IRA and RBA. The request to collect data was made by RBA to all the identified respondents and consent was fully obtained. Each of the organization was requested to identify two managers specifically dealing with annuities. The respondents were called to a central place where focus group discussions took place – in total, 43 respondents took part in the discussions. A discussion with five respondents was first undertaken (a week before) to identify the main issues that would be discussed in the main discussion forum.

For the demand side study, three focus group discussions were conducted with identified pensioners. The discussions formed the basis of enriching the draft questionnaire that had initially been developed by use of literature review sources. The questionnaire was then piloted with 51 respondents before being administered to 450 respondents. The respondents were first contacted on telephone and consent obtained to collect data from them. The respondents were then traced in various areas in Kenya, where they were requested to meet at a central place. The researchers then administered the questionnaires. Some respondents however insisted on phone interviews and emailed questionnaires instead of physical contact. In all, 12% of the data was collected on phone, 4% by use of email and 84% by use of self administered questionnaires. Where practical, focus group discussions were conducted.

### **2.6 Data Analysis**

Qualitative data was transcribed and categorized in to specific themes that reflected the characteristics of the study. A conceptual model to improve the performance of annuities market and performance was then developed. Quantitative data was described by use of descriptive statistics. The pension replacement rate was determined as the proportion of the retirement income to the final salary at the time of retirement.

## Findings

### 3.1 The Annuity Market in Kenya

The findings are based on 100% response rate from insurance companies (supply side) and 82% response rate on the pensioners (supply side).

#### 3.1.1 Number of Annuities Traded

In three years (2009-2011), the annuity market in Kenya was served by 8 companies and in total opened 14007 accounts as indicated in table 1. The distribution shows that 95% of the accounts are held by three companies namely; ICEA Lion (55%), Pan Afric Life (21%) and Jubilee Insurance Company (19%).

**Table 1 Number of Annuity Accounts**

Company	2009	2010	2011	Total	Percentage Distribution
Madison	81	114	133	328	2.3
Jubilee	788	897	968	2,653	18.9
Apollo	11	39	40	90	0.6
ICEA Lion	2280	2685	2811	7,776	55.5
Pan Afric Life	512	655	1753	2,920	20.8
UAP	4	5	9	18	0.1
Kenindia	52	53	53	158	1.1
Britam	4	15	45	64	0.5
<b>Total</b>	<b><u>3,732</u></b>	<b><u>4,463</u></b>	<b><u>5,812</u></b>	<b><u>14,007</u></b>	<b><u>100</u></b>

#### 3.1.2 Value of Annuities Traded

In the three years to 2011, the total value of annuities traded amounted to Ksh. 20 billion. The amount grew by 12.5% in 2010 and 32.2% in 2011. The three main companies; ICEA Lion, Pan Afric Life and Jubilee Insurance company controlled 92% of the value of the annuities traded as indicated in table 2.

**Table 2: Value of Annuities Traded**

Company	2009	2010	2011	Total Value	
Madison	105,856,487	145,614,018	182,487,602	433,958,107	2
Jubilee	1,580,000,000	1,807,000,000	2,027,000,000	5,414,000,000	27
Apollo	27,282,880	62,811,650	85,110,746	175,205,276	1
ICEA Lion	3,264,893,655	3,352,171,421	3,635,798,463	10,252,863,539	51
Pan Afric Life	406,000,000	560,000,000	1,800,000,000	2,766,000,000	14
UAP	16,533,964	3,996,560	18,721,674	39,252,198	0
Kenindia	239,161,700	290,261,700	290,261,700	819,685,100	4
Britam	9,161,021	29,913,071	119,398,427	158,472,519	1
<b>Total</b>	<b><u>5,648,889,707</u></b>	<b><u>6,251,768,420</u></b>	<b><u>8,158,778,612</u></b>	<b><u>20,059,436,739</u></b>	<b><u>100</u></b>

### 3.1.3 Value per Annuitant

The average investment per annuitant was Ksh. 1.5 million in 2009 and Ksh. 1.4 million in both 2010 and 2011. Table 3 shows that the amount per annuitant varied significantly amongst the companies. While Kenindia Insurance has a market share of 1.1% and controlled 4% of the value of annuities traded, it had significantly higher investment per annuitant compared to the other companies. Kenindia has only one annuity product that offers a 10 year guarantee and a consequent life annuity. The two main companies; ICEA Lion and Pan Afric- Life had negative deviations from the 2011 mean implying that these companies focus on high volumes and low value while Kenindia Insurance focuses on high values and low volumes.

**Table 3: Amount Per Annuitant**

Company	2009	2010	2011	2011 Deviation from Mean
<b>Madison</b>	1,306,870	1,277,316	1,372,087	(31,694)
<b>Jubilee</b>	2,005,076	2,014,493	2,094,008	690,227
<b>Apollo</b>	2,480,262	1,610,555	2,127,769	723,987
<b>ICEA Lion</b>	1,431,971	1,248,481	1,293,418	(110,363)
<b>Pan Afric Life</b>	792,969	854,962	1,026,811	(376,970)
<b>UAP</b>	4,133,491	799,312	2,080,186	676,404
<b>Kenindia</b>	4,599,263	5,476,636	5,476,636	4,072,854
<b>Britam</b>	2,290,255	1,994,205	2,653,298	1,249,517
<b>Total</b>	<b><u>1,513,636</u></b>	<b><u>1,400,800</u></b>	<b><u>1,403,782</u></b>	

## 3.2 Demand Side Attribute of the Annuity Market in Kenya

To understand the demand side aspect of the annuity market in Kenya, data was collected from 361 annuitants. Table 4 shows that majority of the respondents were male (77.3%), within the ages of 56 and 67 years (65.1%), married (80.8%), with high school education (40.9%) and only changed jobs once or twice within their working careers.

**Table 4: Demographic Characteristics of the Sample**

Characteristic		Frequency	Percentage
<b>Gender</b>	Male	279	77.3
	Female	82	22.7
	<b>Total</b>	<b>361</b>	<b>100.0</b>
<b>Age (years)</b>	50-55	62	17.1
	56-61	116	32.2
	62-67	119	32.9
	68-73	52	14.4
	74+	12	3.4
	<b>Total</b>	<b>361</b>	<b>100</b>
<b>Marital Status</b>	Single	5	1.3
	Married	292	80.8
	Divorced or separated	11	3.0
	Widowed	53	14.8
	<b>Total</b>	<b>361</b>	<b>100</b>
<b>Education Level</b>	Primary School	67	18.6
	High School	148	40.9
	College Certificate	110	30.4
	University	36	10.1
	<b>Total</b>	<b>361</b>	<b>100</b>
<b>Frequency of Job changes</b>	1-2	148	41.0
	3-4	136	37.7
	5-6	60	16.7
	More than 6	17	4.6
	<b>Total</b>	<b>361</b>	<b>100</b>

### 3.2.1 *Investment in Annuities*

Seventy six percent (n=274) of the respondents invested a part of the amounts they received from their retirement schemes in annuities of different insurance companies. Forty two percent of the annuitants did not have critical details of the insurance companies that they invested in (for instance name of the

companies and their physical location). Thirty seven percent of the respondents believed that the annuity is paid by their employers through the insurance companies.

Asked how they heard of the annuity product, 56.3% responded that they heard from the pension administrators, 8% read from the newspapers, 9.2% from the television, 16.1% from insurance agents and 10.3% heard of the product from their retired friends (table 5). The involvement with insurance companies was at an advanced stage after the respondents had already made the choices.

**Table 5: Source of Information on Annuities**

	Frequency	Percentage
<b>Pension Administrator</b>	154	56.3
<b>Newspaper</b>	22	8.0
<b>Television</b>	25	9.2
<b>Insurance Agent</b>	45	16.1
<b>Retired friend</b>	28	10.3
	<b><u>274</u></b>	<b><u>100</u></b>

The respondents invested in joint annuities with spouses (46.3%), guaranteed annuities (29.2%) with 85.1% investing in guaranteed annuities of up to 10 years and fixed life annuities (24.5%) (table 6).

**Table 6: Type of Annuity**

	Frequency	Percentage
<b>Fixed Life annuity</b>	67	24.5
<b>Guaranteed annuity</b>	80	29.2
<b>Joint annuity with spouse</b>	127	46.3
	<b><u>274</u></b>	<b><u>100</u></b>

Table 7 shows that 75.2% of the respondents invested up to Ksh. 2,500,000 in annuities while 24.8% invested more than Ksh. 2,500,000 in annuities.

**Table 7: Amounts Invested in Annuities**

	Frequency	Percentage
<b>Less than 800,000</b>	91	33.3
<b>800,001 - 1,000,000</b>	34	12.4
<b>1,000,001 - 1,500,000</b>	31	11.4
<b>1,500,001 - 2,000,000</b>	39	14.3
<b>2,000,001 - 2,500,000</b>	10	3.8
<b>2,500,001 - 3,000,000</b>	34	12.4
<b>3,000,001 - 3,500,000</b>	16	5.7
<b>3,500,001 - 4,000,000</b>	12	4.4
<b>More than 4,000,000</b>	6	2.2
	<b><u>274</u></b>	<b><u>100</u></b>

The majority of the annuitants (36.7%) are paid less than Ksh. 10,000 per month on the annuity arrangement. All in all 87.5% of the respondents earned less than Ksh. 40,000 per month on the annuity (table 8).

**Table 8: Monthly Income from the Annuity**

	Frequency	Percentage
<b>Less than 10,000</b>	100	36.7
<b>10,001 - 20,000</b>	56	20.8
<b>20,001 - 30,000</b>	48	17.5
<b>30,001 - 40,000</b>	34	12.5
<b>40,001 - 50,000</b>	12	4.2
<b>50,001 - 60,000</b>	14	5.0
<b>60,001 - 70,000</b>	8	2.8
<b>70,001 - 80,000</b>	2	0.5
	<b><u>274</u></b>	<b><u>100</u></b>

Of the respondents who invested in annuities, 52.2% stated that the specific features of the annuities were not explained to them by the insurance companies and did not fully understand the content of the annuity contract. Of the respondents who knew the features of the annuities, the contract stipulations were explained by; pension administrators (66.7%), family members (4.8%), trustees (4.8%) and insurance agents (14.2%) and retired friends (9.5%). This information is explained in table 9.

**Table 9: Who explained the Features of the Annuity?**

	Frequency	Percentage
Pension Administrator	182	66.7
Family member	13	4.8
Trustees	13	4.8
Insurance agents	39	14.2
Retired friend	26	9.5
	<b><u>274</u></b>	<b><u>100</u></b>

### 3.3 Awareness of Annuity Features

Sixty percent of the respondents stated that they do not have knowledge on the insurance companies that offer annuities, 55.8% do not know the rates of return on annuities, 63.7% are not aware of inflation adjustments for annuities, 56.6% do not understand the need to inform insurance companies in case of change of major issues in their lives, 62.3% do not know that they can borrow on the strength of their annuity income and 68.9% have no idea of how their monthly annuity was arrived at. Forty percent of the annuitants however know the expiry dates for their annuity contracts. These statistics are stated in table 10.



**Table 10: Awareness of the Features of Annuities**

Annuity Aspect	Not at	Small	Very Large	Mean
	all	Extent	Extent	
	1	2	3	
	%	%	%	
<b>The companies that offer annuities</b>	59.6	22.8	17.5	1.58
<b>The rates of return expected on annuities</b>	55.8	28.3	15.9	1.60
<b>Inflation adjustment for annuities</b>	63.7	22.1	14.2	1.50
<b>Need to inform the insurance company in case of changes in major issue (address, death)</b>	56.6	20.4	23.0	1.50
<b>The fact that I can borrow a loan on the strength of annuities</b>	62.3	24.5	13.2	1.66
<b>The expiry date of my annuity</b>	38.6	21.9	39.5	2.01
<b>The formula used to arrive at the monthly amount that I am paid</b>	68.9	21.7	9.4	1.12

Female annuitants recorded low levels of awareness on the features of the annuities than their male counterparts. Sixty percent of the female annuitants' who were not aware (at all and small extent) of the companies that offered their annuities, 69% could not explain the rates of return expected on annuities, 74% had no idea on inflation adjustment, 67% were not aware of the need to inform the insurance company in case of changes in major issues, 54% did not know that annuities could be used as income to service loans and 82% had no idea on the formula used to arrive at the monthly amounts.

The awareness levels too differed on the basis of pre-retirement training. The annuitants who had undergone through a pre-retirement training recorded higher levels of awareness of the factors. Those annuitants who received pre-retirement training from administrators further showed higher level of understanding on the need to inform the insurance company in case of changes in major issues and the expiry dates of the major annuities. A correlation analysis did not determine significant differences in the awareness of annuity features on the basis of age, type of annuity held and the amount invested in annuities.

### 3.4 Pension Replacement Rates

The old-age pension replacement rate measures how effectively a pension system provides a retirement income to replace earnings, the main source of income before retirement (OECD, 2011). The gross replacement rate is therefore defined as gross pension entitlement divided by gross pre-retirement earnings. To derive the pension effect, we divided the monthly pension income with the monthly employment income before retirement. The results show a weighted average replacement rate of 19.2%. Table 11 shows that

**Table 11: Pension Replacement Rates – Annuity Effect**

Replacement Rate %	Frequency	Percentage
<b>Less than 10%</b>	39	14.2
<b>11-15%</b>	32	11.6
<b>16-20%</b>	58	21.3
<b>21-25%</b>	108	39.5
<b>26-30%</b>	33	12.1
<b>31-35%</b>	6	2.3
	<b><u>274</u></b>	<b><u>100</u></b>

The overall replacement rate was recalculated to include the total lump sum income that the annuitants earned on retirement. Assumptions were made to the effect that the earnings will be distributed over a period of 10 years, at a savings rate of 1.25% per annum with annual withdrawals. Recalculating the income replacement rate as the ratio of total post-retirement income (lump sum and annuity) to the pre-retirement income discloses a 34.3% gross replacement rate as indicated in table 12.

**Table 12: Overall Replacement Rate**

Replacement Rate %	Frequency	Percentage
Less than 20%	9	3.3
21-25%	17	6.2
26-30%	56	20.4
31-35%	74	27.0
36-40%	66	24.1
41-45%	33	12.0
46-50	15	5.5
51-55	4	1.5
	<b>274</b>	<b>100</b>

### 3.5 Critical Review of Annuities in the Kenyan Retirement Industry

Focus Group Discussions with the annuity providers disclosed two main options for annuity provision in Kenya; life annuities and guaranteed annuities (table 12). Combinations of the products are not currently available.

**Table 13: Main Annuity Products and Features**

Feature	Life Annuity	Guaranteed Annuity
Immediate liquidity to the annuitant	Provides lower liquidity	Provides higher liquidity
Protection against longevity risk	Full protection	Provides limited protection for the period of contract
Bequest in the event of death	No bequests can be claimed	Bequests can be claimed
Inflation adjustment	Possible for inflation indexed life annuities and impossible for fixed life annuities	No possible as the period is fixed
Nature of the Contract	Irreversible	Irreversible

*Life annuities* provide protection from longevity risk. Buying a life annuity at retirement is an irreversible decision under which retirees lose ownership of their accumulated assets, but they offload longevity risk to the annuity provider. In Kenya options exist for life annuities to be held jointly with spouses.

A *fixed life annuity*, is a stream of income paid at some regular interval for as long as the individual lives, which can be expressed in terms of the final salary, which constitutes the replacement rate. The main hurdle with fixed life annuities is that the purchasing power of the constant periodic stream of income falls over time as long as there is positive inflation. This can however be solved by indexing the fixed life annuity to inflation; although it will still result to lower values for the annuitants.

Guaranteed annuities provide the annuitants with a fixed amount of income for a specific period of time. Once the period expires the annuity ceases. The guaranteed annuity therefore safeguards against longevity for the contract period and provides for bequests if the annuitant passes on within the contract period. The risk with guaranteed annuities is that the annuitants may outlive their savings and are generally not indexed to inflation.

### ***3.5.1 Merits of using Annuities***

Focus Group Discussion results with providers of annuities in the Kenyan market concluded that the suppliers of annuity products benefit from the annuity market because annuities leads to stable markets as funds are available for investment for a long time and the scheduled withdrawals are certain , creates business for insurance companies and enables cross-selling of the other products offered by the service providers in addition to minimizing inflation as the funds invested in annuities would otherwise increase the supply of funds in the economy.

The annuity providers were of the opinion that annuities also benefit the pensioners in that they transfer longevity risk to insurance companies, reduce old-age poverty, can be used as regular income to service scheduled obligations such as loans, enhances social standing, reduces old age dependency, gives the investor a passive income, enables financial planning and instills financial discipline by locking out liquidity. The responding pensioners were asked to rate the extent to which they realized the benefits mentioned by the service providers. The results are indicated in table 13.

**Table 14: Benefits of Annuities to Pensioners**

	Disagree 1 %	Agree 2 %	Strongly Agree 3 %
<b>Have a secure monthly income</b>	20.7	47.1	32.2
<b>Borrow loans on the basis of annuity</b>	58.7	34.7	6.7
<b>Providing for your dependents</b>	31.7	30.0	35.5
<b>Get tax advantages (the income is exempt from tax)</b>	31.4	41.3	27.3
<b>Has improved my social standing and improved relationships</b>	30.6	38.0	31.4
<b>Be self-dependent financially</b>	26.3	32.5	41.2
<b>Get a passive income – income without working</b>	40.8	37.5	21.7
<b>Access medical insurance</b>	31.4	28.9	39.7
<b>Prevent misuse of the funds</b>	26.1	34.1	39.8
<b>Cover increased cost of living (if the annuity is adjusted for inflation)</b>	<b>86.2</b>	<b>8.3</b>	<b>5.5</b>

Table 14 shows that the aforementioned benefits are realized except the issue of annuitants getting loans on the strength of annuity income and annuities shielding the investors on the increased cost of living.

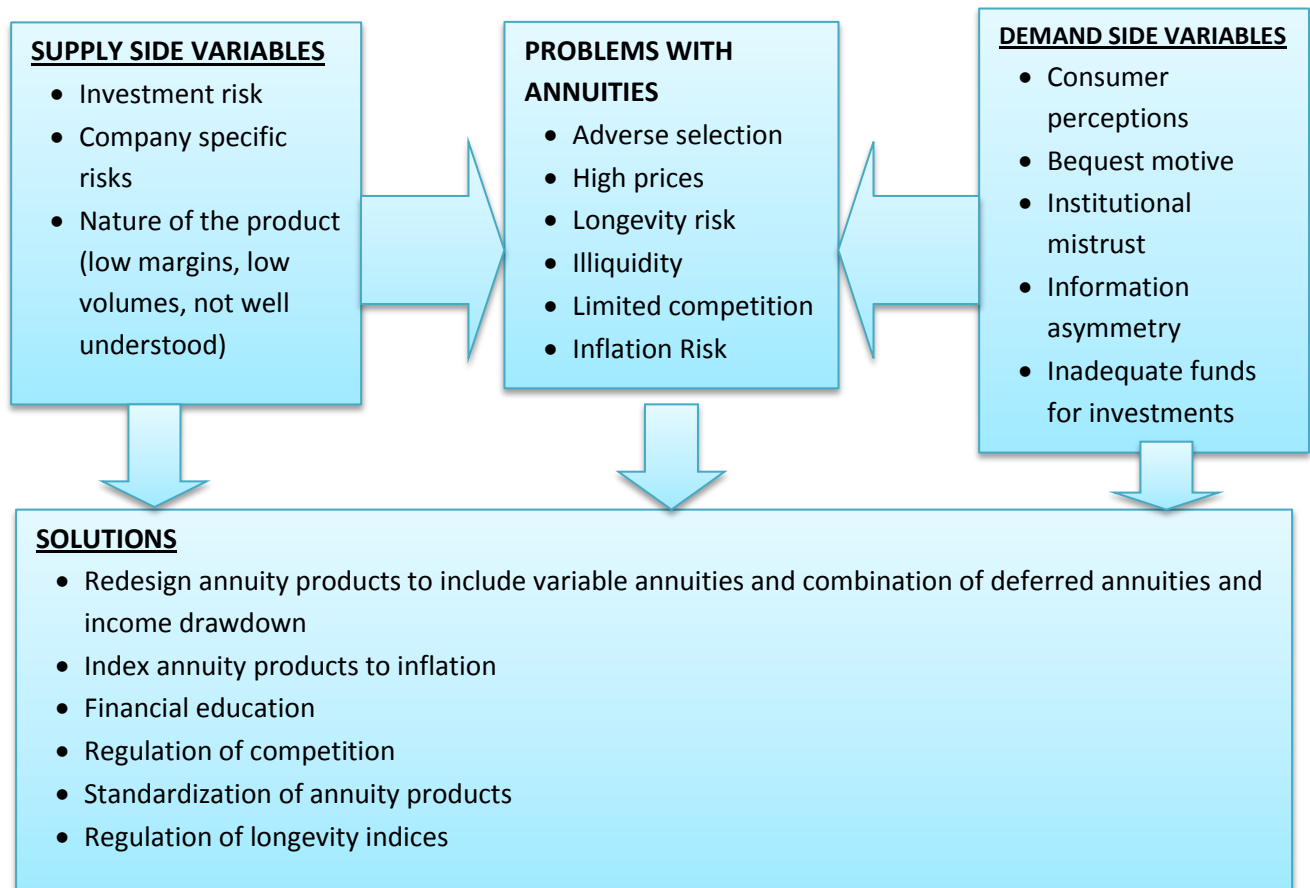
### **3.5.2 Challenges with Annuities in Kenya**

Annuity markets suffer from constraints that stem from demand and supply concerns. On the supply side, the constraints relate to Pricing problems related to adverse selection, lack of competition among providers – due to dominance by a few companies, longevity risks and the demand for annuity products involving many guaranties, coupled with the problems annuity providers encounter to deal with longevity risks are the main supply challenges facing policy makers to promote annuitization, and encourage further expansion of annuity markets while on the demand side, the constraints relate to; failure to meet the annuitants expectations, regulatory constraints, annuitants failure to understand the concept of annuities, perception that the prices are high, failure to provide for bequests and inflation adjustments, mistrust of the annuity providers and little income that makes the resulting annuity trivial. Antolin (2009) find that lack of inflation indexation could reduce the purchasing power of retirement income by as much as one-third in 20 years.

### 3.5.3 *Enhancing the Annuity Market in Kenya*

Figure 1, developed from the themes generated by the focus group discussions with service providers and pensioners identifies the problems with annuities as; adverse selection by the service provider, high prices, longevity risk, illiquidity, limited competition amongst service providers and inflation risk. These problems are caused by the supply side aspects namely; investment risk, company specific risks and the nature of the products as well as the demand side aspects namely; consumer's perceptions, bequest motive, institutional mistrust, information asymmetry and inadequate funds for investment. The model hypothesizes that the problems with annuities can only be solved by critically addressing both the demand and supply sides. Specific measures to take include; development of variable annuities, combining deferred annuities with an income drawdown (programmed withdrawal), indexation of annuity products to inflation, financial education to consumers, regulation of the competition, standardization of annuity products available in the market and regulation of longevity indices.

**Figure 1: Conceptual Model to Improve Retirement Income Provision by use of Annuities**



### 3.6 Alternatives to Annuities

This section addresses different models in which retirement income may be provided to the beneficiaries. The models expounded are lump-sum payments, income draw downs and a combination of deferred annuities and income drawdown.

#### 3.6.1 *Lump sum Payment*

With lump-sums, retirees are paid the whole value of the assets accumulated for retirement in a single payment with no restrictions on how the funds will be used. Retirees can then invest, buy annuities, clear debts or spend freely on discretionary items. Pension payments on lump-sums require strong financial discipline and management skills, which may not be prevalent amongst many individuals. Lump-sum payments further fail to provide protection from longevity risk.

Evidence of payment of pensions on lump-sum is evident in Malaysia, Hong Kong and Sri Lanka while Indonesia offers a choice of a single lump-sum or annual payment over five years.

### 3.6.2 *Income Drawdown*

Under the income drawdown model, individuals commit to an agreed plan of periodic fixed or variable payments. Two options exist for the programmed withdrawals namely; fixed and variable programmed withdrawals (table 15). In this regard, income drawdowns provide more financial discipline than lump-sums while maintaining some flexibility, access to liquidity and the possibility of leaving bequests. Unfortunately, they also fail to provide any protection from longevity risk.

**Table 15: Options for Programmed Withdrawals of Pension Benefits**

Feature	Fixed Programmed Withdrawal	Variable Programmed Withdrawal
Period involved	Fixed	Fixed
Share of gains from the portfolio	Yes	Yes
Protection against Inflation Risk	Yes <b>IF</b> portfolio returns exceed inflation rate	Yes <b>IF</b> portfolio returns exceed inflation rate
Flexibility of withdrawal of funds	Yes	Yes
Liquidity	Yes	Yes
Bequests to dependents	Yes	Yes
Longevity risk	Retirees are exposed	Retirees are exposed
Amount paid to retiree	Fixed	Variable
Market Risk	Borne by the provider	Borne by the retiree

Incomes drawn from the retirement schemes can be determined by dividing the accumulated amount in various ways, for example, by a fixed number of years or by the expected life expectancy in each period or payments can be flexible. Income drawdown allows pensioners to benefit from gains in portfolio investments. Moreover, as long as returns on investment are above inflation income drawdown protects pensioners from purchasing power losses and allows



for flexibility, liquidity and bequests to dependents. However, income drawdown still exposes the pensioners to longevity risk since the pensioners can outlive their incomes.

A *fixed income drawdown* pays a periodic constant stream of income for a certain period. It can be calculated by dividing the assets accumulated at retirement by an annuity factor corresponding to an annuity certain (Antolin, 2009). In the case of a fixed programmed withdrawal, the downside risk of market returns falls on the pension fund.

A *variable income drawdown* pays a variable periodic stream of income, which is variable because, every year, the amount of assets remaining, adjusted for portfolio gains the previous year, is divided by a changing life expectancy to obtain that year's payment. For example, one might assume the life expectancy at age 65 to be 20 years, that is, the person may live up to the age of 85. However, after reaching 85 the individual's life expectancy may be expected to be eight more years, bringing the age the person may be expected to live to 93, in which case the retiree bears the market downside risk.

### **3.6.3 Hybrid of Deferred Annuity and Income Drawdown**

An alternative model to the retirement benefits payout phase is to combine a deferred life annuity and an income drawdown. The deferred life annuity may be bought before retirement but would start paying pension benefits at a later stage (*e.g.*, age 70 when the income in the drawdown fund is exhausted) or can be bought after the drawdown. The amount remaining after buying the deferred life annuity can be used to finance an income drawdown for the transitional period (*e.g.* from the age of 60 to 70). This combination protects retirees from longevity risk through the deferred annuity and provides flexibility, liquidity and the bequest needs.

## **Policy Recommendations**

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This study unearths critical findings that policy makers need to embed in their policy initiatives to enhance the pension benefits paid to the retirement savers. The main findings and policy recommendations are explained in this section.

The success of the payout phase in the retirement cycle depends a lot on its input stage namely; the accumulation phase. Measures should then be undertaken to strengthen the accumulation pillar. Specific to this study, we find that the retirement incomes of the pensioners who changed jobs frequently were significantly less than those who changed less often. Policy makers should therefore revisit the portability of retirement benefits when employees change jobs.

Approximately two-thirds of the respondents did not undergo any form of pre-retirement training or counseling. This situation should be remedied by embedding pre-retirement training as a component in the accumulation phase of the retirement schemes annually. This can be achieved by mandating retirement schemes with employees who reach the age of early retirement (50 years) to conduct such training with an RBA approved trainer. Moreover, different pre-retirement trainings yield different outcomes on investor choices hence the need for an integrated and well-coordinated approach to pre-retirement training.

The study finds that annuity markets are critical for the success of the payout phase of the retirement savings cycle since they present the only way to manage longevity risks. The markets are however subject to serious demand side and supply side constraints that can be addressed by;

- (a) Redesigning the annuity products to include variable annuities, income drawdown and deferred annuities options to increase their liquidity
- (b) Regulation of competition since the annuity market seems to be dominated by three major companies and pension administrators are the main advisors on the types of annuities. Additionally, regulation should focus on the review of longevity tables after some time for instance five years to reflect the real value of annuities.
- (c) Standardize different annuity products offered in the market. This will ensure that insurance companies compete on the basis of efficiency, effectiveness and price as opposed to the product features

The study discloses low awareness levels on annuities and the payout phase generally on the pensioners. We recommend financial education through the retirement schemes so that individuals can have targeted training.

To allow for flexibility and liquidity, regulators should encourage retirement benefit schemes to create income drawdown funds and also maximize on the benefits of a hybrid of deferred annuities and income draw downs.

## Conclusions

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When choosing between different retirement benefit payout options, a delicate balance needs to be maintained between protection from longevity risk on one side and flexibility, liquidity and

bequests on the other. Fixed life annuities protect against longevity risk but fail to shield pensioners from rising cost of living and provide the much needed liquidity; guaranteed annuities provide for bequests and relative liquidity and certainty on pension income provision but fail to protect individuals from inflation and longevity risks. The income draw down model provides liquidity and flexibility but fails to protect individuals from market and longevity risks. On the other hand lump-sum payments on retirement provide liquidity but are inefficient choices when individuals lack financial discipline and management skills. Moreover, lump-sums are the weakest options in the coverage of longevity risks and inflation. Stakeholders in the retirement benefits industry are advised to embrace different payout options and provide choices to individuals so that they can factor in their individual factors in the choice of the payout model.

### **5.1 Limitations of the Study and Suggestions for Further Research**

Although this study has contributed to important policy considerations, it is worth mentioning that the study used a multiplicity of approaches to collect data. The methods of data collection used were structured interviews, focus group discussions, phone interviews and questionnaires. Although deliberate and absolute care was taken to avoid altercation, a degree of altercation cannot be overruled when such approaches are used. Additionally, the researchers developed a sampling frame of the pensioners from the records kept by the administrators. The sampling frame was therefore only accurate to the extent of the accurateness of the records maintained by the administrators.

The study has generated baseline data on pensioners at a time when the Retirement Benefits Authority has implemented income drawdown rules for retirement benefit schemes in Kenya. It will be important to design an impact evaluation study at this stage. The study will seek to collect baseline data on pensioners who are retiring in 2012-2013 financial year, monitor their choices and eventually compare replacement rates and other indicators after a period of time.

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